## Caprin Asset Management, L.L.C.



Caprin Asset Management's disciplined investment process is dedicated to helping investors navigate the complexities of the municipal bond market by preserving and enhancing investor wealth through thoughtfully constructed, professionally managed portfolios.

April, 2003

When we wrote our quarterly market update in January, there was significant talk of war with Iraq and all of the ramifications of a drawn out and difficult war. The reality is that we prepared for, launched, and appear now to have successfully concluded a war with Saddam Hussein and liberated the Iraqi people. While difficult political times lay ahead, President Bush now faces an economic agenda with extremely favorable ratings in the polls. A supportive Congress should allow the President to implement a major portion of the tax reduction bill. However, the markets need more than tax reductions; the markets need a big dose of confidence. After the third bad year of equity returns, the risk premium has grown significantly. Since the beginning of the year, we have seen significant volatility in the fixed income markets, but net net very little change. As expected, the fixed income markets rallied when the equity markets fell, and vice versa. During the war volatility levels increased as each bomb fell. Cries from the media sent the markets rolling: "They are bombing Iraq, Saddam lives, POWs were taken, POWs were released." Back and forth the news went.

Fundamental analysis may again have a place in the valuations of investment securities. In fixed income, the two main concerns are the growing budget deficit and the shrinking revenue base of municipalities. Other potential negatives include investors swapping fixed income assets for equities, too much supply of corporate debt as companies take advantage of the current low interest rates, and the potential for political backlash leading to a decline in the appetite for U.S. investments by foreigners, ultimately putting pressure on the dollar. This all means that interest rates can rise.

It may however, take some time before the Federal Reserve contemplates raising short-term interest rates. The economy has been very weak and the Fed has therefore held a very accommodative policy. Until there is a clear sign that the economy is back on its feet, the Fed would not want to signal anything besides being accommodative. After all, next year is an election year!

Through the ups and downs of the quarter, municipal investments in our composite were up, earning both the coupon and some appreciation. As we alluded to in our comments above, we expect interest rates to eventually rise, so we will be content with earning the coupon for the year. In March we changed our strategy from that of a ladder (maturities in each year) to more of a barbell where we emphasize 2-3 year maturities balanced with 10-12 year maturities, ending up with the same 4 year average duration. As 4 years is fairly short, this keeps the potential for principal losses minimized in a rising rate environment, and the barbell outperforms when the short-end of the yield curve rises more than the long-end. With inflation expectations controlled, there is still no reason to think that long-term interest rates need to rise substantially. The yield curve is historically steep and can flatten back to historical averages.

Our philosophy is that higher rates will ultimately help our investors as the relatively short maturity of our portfolios will allow us to reinvest at higher rates. We are prepared to take advantage of these opportunities on your behalf. Thank you for entrusting us with the management of your portfolio. We will continue to work diligently at Capital Preservation and Income management.

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